

Internal Revenue Service
memorandum

CC:TL-N-5639-88
Brl:CEButterfield

date: MAY 19 1988

to: District Counsel, St. Paul

CC:STP

from: Director, Tax Litigation Division

CC:TL

subject: [REDACTED]

This responds to your request for technical advice dated April 20, 1988.

ISSUE

Whether the taxpayer may include purchased inventory in a single inventory pool with similar inventory which it manufactured. 0472-0800.

CONCLUSION

The taxpayer may not include purchased inventory in the same inventory pool with manufactured inventory. I.R.C. § 472-8(a). There is no de minimus exception to the requirement that manufacturers who also engage in wholesale or retail activities inventory goods related to those activities separately.

FACTS

The taxpayer, [REDACTED], is in the business of manufacturing [REDACTED] parts. In its taxable year ended [REDACTED], [REDACTED] purchased the assets of another company engaged in the same business. Among the assets purchased was the finished inventory of that company, consisting of [REDACTED] parts identical to those manufactured by [REDACTED]. [REDACTED] records its inventory under the LIFO method using natural business unit pools ("NBU pools"). [REDACTED] included the purchased [REDACTED] parts in the NBU pool with parts it had manufactured. [REDACTED] asserts that the single purchase of inventory in an asset acquisition will not place it under the requirements of Treas. Reg. § 1.472-8(b)(2) that wholesale or retail activities be inventoried separately. They state that the isolated nature of the purchase is not within the intent of the regulation. As further support for their position they state that the inventory purchased was subject to a pre-existing

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purchase order which [REDACTED] was obligated to honor. This case is scheduled for trial in June.

LEGAL ANALYSIS

Section 471 of the Code requires that taxpayers account for the sale of income producing items by the use of inventories, and the accrual method, where necessary to clearly reflect income. Section 472 allows any taxpayer so required to use inventories to elect the LIFO method as an assumption of the flow of goods in the inventory. A LIFO taxpayer may account for inventory by the specific goods method or the dollar value method. [REDACTED] uses the dollar value method as authorized by Treas. Reg. § 1.472-8(a).

Manufacturers who use the dollar value method (expressing the value of LIFO inventories by the total dollar value of the inventory rather than by the number and price of specific goods within the inventory) group inventory items into pools. Pools are generally to consist of all items in the inventory of a natural business unit of an enterprise. The term natural business unit is defined at Treas. Reg. § 1.472-8(b)(2) for manufacturers to consist generally of "the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods." The regulation goes on to require that "[w]here a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered part of any manufacturing or processing unit." Treas. Reg. § 1.472-8(b)(2).

The appropriate placement of goods in individual NBU pools is a question of fact, to be guided by the facts and circumstances of each case. However the purpose of allowing the LIFO method and the use of NBU pools within that method is to reflect the effects of price fluctuations and cost fluctuations within the industry, and to allow goods bearing the burden of recent inflation effects to be accounted for as sold at the most recent prices, which presumably also reflect the effects of the same inflationary factors. Goods purchased in the acquisition of a company are not subject to the same market effects as are goods manufactured within the corporation. Assets purchased from a liquidating corporation are likely to be obtained at a discount. Inclusion of discounted goods (or, if applicable, goods purchased at a premium in a contested purchase) into the same NBU pool as manufactured goods introduce elements into the price structure of the pool beyond the normal inflationary cost fluctuations. The result skews the intended effect of

normal LIFO assumptions. Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 (1981); PLR 8545004.

The Service has argued the position that purchased and manufactured goods must be accounted for in separate inventory pools in Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984). In that case the taxpayer was a manufacturer of leather goods, and also purchased for resale identical finished goods from its wholly owned subsidiaries. The Service challenged taxpayer's use of a single inventory pool to account for both the manufactured and purchased goods. The court held that the regulations under section 472 are legislative and must be applied unless plainly inconsistent with the statute they implement. It further held that the regulations clearly require that manufacturers account for purchased goods in separate inventory pools from manufactured goods.

The court also rejected the argument that the manufacturer had such extensive control over the activities of its subsidiaries as to be deemed the manufacturer of the goods purchased from them. One factor weighing in the court's decision on this matter was the fact that the goods were purchased at a profit from the subsidiaries. Similar considerations may be applicable in the [REDACTED] case -- whether the goods were purchased at a profit or at a discount, they would still reflect economic factors other than the normal inflationary factors intended to be addressed by the use of the LIFO method. These arguments are developed extensively in the brief filed in Amity Leather. We have attached a copy of that brief for your reference.

The taxpayer in [REDACTED] is attempting to assert some sort of de minimus exception to the requirements that purchased goods not be included in inventory pools with manufactured goods. They state that they should not be held to be engaged in "wholesaling or retailing operations" because they only made a single purchase of finished goods in an asset acquisition, and do not make a practice of similar purchases. The Service has not recognized an exception to the requirements of the regulations for single purchases. PLR 8545004.

More recently, in PLR 8807036, the Service has allowed an exception to the requirement of separate pools under very narrow circumstances. In that ruling the taxpayer was in the business of refining and retailing certain types of products. It is normal in the industry of the taxpayer to engage in buy/sell arrangements with other taxpayers similarly engaged. These taxpayers buy the goods they refine, but sometimes subsequently sell them to other taxpayers in exchange for the right to purchase other goods more suitable to their own operations (more suitable as to grade, type, etc.) As the goods under these narrow circumstances are only purchased or obtained as part of the normal process of obtaining goods for refining, the Service

permitted them to be held in single pools with other goods actually used in the refinement process, and did not find their acquisition to constitute wholesaling or retailing within the meaning of the regulations. Although [REDACTED] might raise this ruling as an indication that the Service permits exceptions to the general requirement of the 472 regulations, the facts in the ruling are clearly distinguishable from [REDACTED].

Taxpayer has also asserted that the fact that the finished inventory items were purchased subject to a pre-existing purchase order supports its assertion that it was not engaged in wholesaling or retailing operations. In fact, the existence of a purchase order insured that the goods would be resold. Presumably the taxpayer would make the same argument had the goods been subject to 100 separate pre-existing purchase agreements, as long as it did not engage in marketing them. We do not agree with the taxpayer that this agreement should alter the character of the transaction.

In sum, the Service does not recognize an exception to the separate pool requirement for single purchases of inventory items. (If we did recognize an exception, what would prevent the taxpayer from making a similar purchase and similar arguments in a succeeding tax year?) [REDACTED] should account for the purchased [REDACTED] goods separately from the goods it manufactures.

If you have any questions about this matter, please do not hesitate to call Ms. Clare E. Butterfield, at (FTS)566-3442.

MARLENE GROSS

By:

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Attachment:

Amity Leather brief